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CITATIONS

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In the Supreme Court of the United States

October Term, 1942

No. 724

Central West Coal Company, a Corporation, petitioner

v.

Guy T. Helvering, Commissioner of Internal Revenue

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 58–69) is reported at 44 B. T. A. 661. The opinion of the Circuit Court of Appeals (R. 83–86) is reported in 132 F. 2d 190.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered November 11, 1942 (R. 87). The petition for a writ of certiorari was filed February 11, 1943. The jurisdiction of this Court is in-

voked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether, in determining the taxpayer's liability for surtax on undistributed profits under Section 14 of the Revenue Act of 1936, the taxpayer was entitled, in arriving at its "undistributed net income," to any credit under Section 26 (c) (1) of that Act by reason of either the provisions of a deed of trust securing its bonds or the provisions of its preferred stock relative to the payment of dividends.

STATUTES AND REGULATIONS INVOLVED

The statutes and regulations involved are set forth in the Appendix, *infra*, pp. 12–18.

STATEMENT

The Board of Tax Appeals found the following facts (R. 59–62):

The taxpayer is a Michigan corporation, engaged in the coal business. During the taxable years (fiscal years ended April 30, 1937, and April 30, 1938), the taxpayer had outstanding first mortgage bonds, preferred stock, and common stock (R. 59).

The bonds were issued on August 1, 1928, in the total amount of $400,000 par value. They were first mortgage bonds secured by a deed of trust executed by the taxpayer on July 25, 1928,

and bore interest at the rate of 6 percent per annum, payable semiannually, on the first day of August and February in each year. They were to mature serially, beginning with $40,000 on August 1, 1931, and then $30,000 on August 1 of each year thereafter until August 1, 1943; they were subject to redemption prior to maturity upon payment of a premium of 2 percent. The deed provided in part as follows (R. 59–60):

> The Mortgagor further covenants that after the expiration of three years from the date hereof it will not pay any dividend upon its common capital stock until the principal of said bonds then maturing and interest on all outstanding bonds, together with service charges, shall have been provided for. Dividends declared within ninety days after the close of the Mortgagor's fiscal year out of the net earnings of such year shall be considered as dividends declared during such fiscal year for the purposes of this section.
>
> In the event of any misunderstanding or dispute over the proper construction or interpretation of this section and/or its proper application to a given transaction contemplated by the Mortgagor, the determination by a disinterested accountant of recognized good standing selected by the Trustee, shall be final and conclusive upon the parties, and the failure or refusal of the Mortgagor to abide by and follow such determination shall *ipso facto* constitute a default under this mortgage. * * *

The preferred stock was authorized in the amount of $100,000 par value by resolution of the taxpayer's stockholders on April 13, 1921. By the terms of the resolution, and of the stock certificates issued thereunder, this stock was to be redeemed at par on June 1, 1936, with the option on the part of the taxpayer before that date to redeem all or any part thereof at par plus accrued dividends. The resolution and the certificates provided (R. 60):

> The holders * * * shall be entitled to receive in preference to all other stock * * *, but only when and as declared by the board of directors, and only from the surplus or net profits * * * when and as determined by the board of directors, dividends at the rate of * * * seven per centum per annum * * * payable semi-annually * * *. Such dividends shall be cumulative, so that if at any time all dividends on the preferred stock at the rate of seven per centum per annum up to such time shall not have been declared and paid or a sum sufficient for the payment thereof set apart and appropriated to such payment, the deficiency shall be paid or a sum sufficient for the payment thereof set apart and appropriated to such payment before any dividend shall be declared or paid upon or set apart for any other stock * * *. Whenever * * * all cumulative dividends upon the preferred stock for each previous year and

> such dividends then accrued for the current year shall have been declared and paid, or a sum sufficient for the payment thereof shall have been set apart and appropriated to such payment, the board of directors may * * * declare dividends upon the common or other stock * * * payable out of the then remaining surplus or net profits, * * *.

The taxpayer paid interest on and retired the bonds as they matured in accordance with the terms of the deed of trust, including all maturities in the taxable years. It paid principal of the bonds in amounts totaling $220,000 from August 1, 1931, to April 30, 1937, and $250,000 from August 1, 1931, to April 30, 1938. The payments were made from earnings and other funds, such as working capital, reserves, and proceeds derived from the sale of physical assets—the evidence failing to disclose, however, what amounts were paid from any of the several sources mentioned. (R. 60–61.)

The amount of the taxpayer's preferred stock issued and outstanding on April 13, 1933, was $98,600 par value. Between that date and April 15, 1938, the taxpayer retired a substantial part of that preferred stock. The amount, in par value, of the preferred stock outstanding on April 30, 1936, was $59,650, while on April 30, 1937, it was $49,850, and on April 15 and April 30, 1938, it was $36,350. (R. 61.) On April 15, 1937,

there remained accrued and unpaid, on the preferred stock, dividends in the amount of $15,-702.75, and on April 15, 1938, the accrued and unpaid dividends on that stock amounted to $13,994.75 (R. 61).

The taxpayer's earned surplus as of April 30, 1930, was $167,149.95. The earnings and the earned surplus as of the close of the fiscal years ended April 30, 1931, to April 30, 1938, as reflected by the books, are as follows (R. 61):

Year (ended April 30)	Earnings		Earned surplus
	Profit	Loss	
1931		$16,701.29	$135,948.66
1932		46,479.96	82,468.70
1933		8,155.63	70,862.07
1934		23,389.08	47,472.99
1935	$24,034.66		71,507.65
1936	26,295.24		97,802.89
1937	28,219.16		126,022.05
1938	32,788.20		158,810.25

The balance sheets filed with the taxpayer's returns for the two taxable years ending in 1937 and 1938 disclose earned surplus in the respective amounts of $126,022.05 and $158,810.25 as of the close of the taxable years. They further show that the taxpayer had cash on hand in the amount of $96,580.85 at the beginning of the taxable year 1937, in the amount of $165,558.42 at the end of that year, and in the amount of $96,454.38 at the end of the taxable year 1938. (R. 61.)

The profits and losses shown in the above tabulation represent the profits and losses computed

after adding to the net income of each year items of nontaxable income and deducting therefrom items such as life insurance premiums, Federal income taxes, dividends paid, losses, and other items not deductible in computing net income. They do not include any deduction or adjustment on account of the principal payments on bonds or preferred stock retired nor do they include any deduction on account of accrued and unpaid dividends on the preferred stock. (R. 62.)

In its returns, the taxpayer reported adjusted net income of $45,562.55 for 1937 and $43,514.55 for 1938. For each of the two taxable years the taxpayer claimed a credit of $30,000 against the adjusted net income, on account of a contract (the deed of trust) restricting dividend payments, and (further claiming a specific credit of $443.74 for 1937) the taxpayer reported undistributed net income subject to surtax in the amounts of $15,-118.81 and $13,514.55 for the two years, and surtax due thereon in the amounts of $1,917.82 and $1,579.90, respectively. (R. 62.)

In his determination (R. 11–16), the Commissioner determined the adjusted net income of the taxpayer to be $46,079.36 for 1937 and $43,618.25 for 1938. Then, in arriving at the undistributed net income subject to the surtax, he disallowed the credits of $30,000 claimed by the taxpayer in each year (R. 12–13, 15, 16, 62).

In the appeal to the Board of Tax Appeals, the taxpayer attacked the deficiencies asserted

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against it, alleging error in the disallowance of the $30,000 credit claimed in each of the two taxable years, and, after amending its petition, claimed further that it had made overpayments of surtax in the amounts ($1,917.82 and $1,579.90) shown to be due on the returns for those years because it was entitled to other credits, not claimed in the returns, on account of the preferred stock restriction against payment of dividends on its common stock (R. 58–59, 62).

The Board sustained the deficiencies determined by the Commissioner (R. 62–69) and the court below affirmed (R. 83–86).

ARGUMENT

1. Petitioner's principal reason for certiorari is an alleged conflict with *Lehigh Structural Steel Co.* v. *Commissioner,* 127 F. (2d) 67 (C. C. A. 3). But there is no more substantial basis for certiorari here than in *Warren Tel. Co.* v. *Commissioner,* 128 F. 2d 503 (C. C. A. 6), where a conflict with the *Lehigh* case was similarly alleged and where this Court, on January 11, 1943, denied certiorari, No. 550, present Term.

To be sure, the court in the *Lehigh* case held that provisions restricting the payment of dividends which appeared upon stock certificates could constitute a "contract" within the meaning of Section 26 (c) (1) of the 1936 Act, whereas the decisions here and in *Warren Tel. Co.* v. *Commissioner* indicate that such certificates are

not contracts within the meaning of Section 26 (c) (1). The significant consideration, however, is that regardless of whether such certificates are "contracts," the provisions in question are otherwise outside the scope of Section 26 (c) (1) both in this case and in the *Warren Tel. Co.* case for reasons which do not touch the *Lehigh* case.

The provisions of the stock certificates here involved simply forbid the distribution of dividends upon the common stock until dividends have been paid upon the preferred. But these provisions do not restrict the payment of either the delinquent or current dividends upon the preferred, which, as noted by the Board (R. 67–68), the taxpayer was financially able to pay; and upon payment of those dividends, the taxpayer would then be able to pay dividends upon its common. Thus, the provisions here involved merely established the order in which dividends may be paid to the two classes of stockholders. The purpose of the credit in Section 26 (c) (1) was to give relief to a corporation that could not pay dividends that would be taxable to the recipients. Here, however, the corporation could pay such dividends; it was merely required to pay them first to the holders of the preferred stock.

2. The second question upon which petitioner seeks review is whether its trust deed should be construed so as to prohibit payment of dividends

upon its common stock until all bond maturities and interest have been provided for out of earnings. The Board of Tax Appeals and the court below both held, correctly, we submit, that these obligations did not have to be met entirely out of earnings and it is undisputed that they were in fact paid from other sources as well (R. 27, 60–61, 65, 85; Pet. 16).

3. Moreover, even if the preferred stock and bond provisions were regarded as contracts restricting payment of dividends, nevertheless the taxpayer would not be entitled to the claimed credits. Section 26 (c) (1) allows a credit only for the excess of the adjusted net income over the aggregate of the amounts which can be distributed within the taxable year as dividends without violating such a contract. The taxpayer had enough *accumulated* earnings to have permitted it to meet the current bond retirement and interest and all preferred dividend obligations therefrom, thus enabling it to distribute its current earnings as dividends. See opinion of the Board of Tax Appeals (R. 68–69); *L. O. Koven & Brother, Inc.* v. *Commissioner,* 47 B. T. A. 467, 471, affirmed *per curiam* by the Circuit Court of Appeals for the Third Circuit on January 11, 1943 (1943 C. C. H., par. 9244); *Thew Shovel Co.* v. *Commissioner,* 45 B. T. A. 920, 927, affirmed on the opinion of the Board of Tax Appeals, February 11, 1943 (C. C. A. 6th). Both the

Board of Tax Appeals (R. 61, 68–69) and the court below (R. 84, 86) accepted as correct the figures shown on the taxpayer's books (R. 26, 54) with respect to its surplus. The calculations submitted by taxpayer purporting to show a deficit (Pet. 6–7) are based upon arbitrary deductions from the book figures. These calculations have no probative value and the record affords no basis for any contention that the taxpayer's books do not reflect its true surplus. Cf. *Doyle* v. *Mitchell Brothers Co.*, 247 U. S. 179, 187. The taxpayer has not shown itself entitled to any relief under Section 501 of the Revenue Act of 1942 (Appendix, *infra*), which amends the Revenue Act of 1936, and allows additional credits in the case of deficit corporations. The court below so concluded (R. 86) and the taxpayer has not raised any point as to this in the petition for certiorari.

CONCLUSION

The decision is correct and the petition should be denied.

Respectfully submitted.

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